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C O N F I D E N T I A L SECTION 01 OF 02 ANKARA 001713

SIPDIS

STATE FOR E, P, EUR/SE AND EB
TREASURY FOR U/S TAYLOR AND OASIA - MILLS
NSC FOR QUANRUD AND BRYZA

E.O. 12958: DECL: 09/02/2006
TAGS: ECON PREL TU
SUBJECT: TURKISH ECONOMY COB 3/18: RETURN TO NEVER NEVER LAND; CENTRAL BANK GOVERNOR'S CONCERNS

REF: ANKARA 1692

Classified by Econ Counselor Scot Marciel for reasons 1.5 (b,d).

¶1. (C) Summary: Reports that the U.S. financial package was back "on the table" sustained the market's rally this afternoon, with the lira closing at TL 1,648,000 and t-bill yields ending at slightly under 60 percent. CB Governor Serdengecti warned us that, should Parliament pass a second resolution based on the expectation of the full U.S. package only to find out the package was not forthcoming, the result would be political dynamite. He expressed doubt that Turkey could manage its economy through the coming months. End Summary.

Markets Return to Never Never Land

¶2. (U) At COB March 18, Turkish markets consolidated the rebounds of the morning, erasing the losses of Monday, all based on local press reports that the full U.S. financial package remains valid (see reftel). Markets expectations were strengthened by a late afternoon press comment from PM Erdogan, who confirmed that tonight's Cabinet meeting would discuss a parliamentary resolution and that it would be submitted to parliament either Wednesday or Thursday at the latest.

-- Treasury bill yields ended the day at slightly under 60 percent compounded.

-- The lira ended at TL 1,648,000 to the dollar.

-- The Istanbul Stock Exchange closed up 11.5 percent. Transaction volumes remained heavy in all markets.

¶3. (SBU) The main winners in the market's 24 hour see-saw were local brokers and traders. JP Morgan/Chase's Turkish bond trader Gumisdis summed up the current local market expectation as follows: the Erdogan government would submit a new parliamentary resolution to parliament by Thursday, which would include authorization for U.S. troops (both because this is the money part and because the Turkish military wants to go into Northern Iraq with the U.S. troops). The new resolution would then unlock a very sizable U.S. package to include the $8.5 billion bridge loan.

¶4. (SBU) Asked if he believed in this scenario, Gumisdis laughed and said no, but that many people in the market did and that was sufficient to last until probably the morning of Thursday March 20.

Warning from Governor Serdengecti

¶5. (C) In a meeting today with EconCouns, Central Bank Governor Serdengecti warned that renewed expectations of the full U.S. assistance package, fueled in part by MinState Babacan's public statements this morning, created major risks. If, he continued, parliament passed a military cooperation resolution based on this expectation, and the U.S. package was not forthcoming, there would be a major negative reaction in the markets and the public. This would put tremendous pressure on the government, perhaps squeezing it out of office. In that case, AK could well make very bad decisions affecting both the economy and the bilateral relationship, he warned. "They have acted irrationally in

the recent past, and can be counted on to do so again."

¶7. (C) Serdengecti added that, without a U.S. financial package closely tied to the IMF program, he doubted that the GOT could manage its debt service this year, even if it were to begin fully implementing the IMF-backed reform program. The problem, he continued, was market expectations. Two months ago it would have been possible to get by through strengthened reform implementation. But now the GOT has created the expectation that an IMF program is not enough; they need "something extra." Now, only some amount of money from a U.S. package -- and he admitted he did not know what that amount was - would suffice to create market confidence.

¶8. (C) Continuing the worst case scenario of GOT passing a resolution but not getting U.S. financial support, Serdengecti said the likely GOT reaction would be to blame the U.S. for the consequent market downturn (which would unfortunately find a receptive audience, he noted), and to openly consider debt restructuring and other draconian steps (e.g., imposing capital controls.) He noted that AK members of parliament were already muttering about getting rid of the IMF and U.S. influence, and incorrectly citing the example of Malaysia, which imposed capital controls in very different circumstances.

PEARSON